INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	2
Specification of errors to be urged	3
Reasons for granting the writ	4
Conclusion	6
Appendix	7

CITATIONS

Cases:	
Helvering v. *Bankline Oil Co.*, No. 387, October Term, 1937	6
Helvering v. *Twin Bell Syndicate*, 293 U. S. 312	5, 6
Palmer v. *Bender*, 287 U. S. 551	4
Thomas v. *Perkins*, decided June 1, 1937, No. 824, October Term, 1936	4, 5
Statute:	
Revenue Act of 1926, c. 27, 44 Stat. 9:	
Sec. 204	7
Sec. 214	7

14689—37

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THOMAS A. O'DONNELL

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered in this cause on June 14, 1937.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 47–52) is reported in 32 B. T. A. 1277. The opinion of the Circuit Court of Appeals is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 14, 1937. The jurisdiction of

this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether one acquires a depletable interest when he sells his stock in one corporation to another which "agrees to pay therefor * * * one-third (⅓) of the *net profits* received by it * * * from the development and operation" of oil leases, which the purchaser corporation agrees to acquire from the first corporation.

STATUTE INVOLVED

The statute involved will be found in the Appendix, *infra,* pp. 7–8.

STATEMENT

Thomas A. O'Donnell, an oil operator, owned one-third of the capital stock of the San Gabriel Petroleum Company, which he sold to the Petroleum Midway Company, Ltd., by written contract on January 9, 1918. (R. 44.)

As consideration for such stock Midway agreed to pay O'Donnell one-third of the *net profits* from the development and operation of the properties enumerated in leases then owned by the San Gabriel Company. (R. 78.) Midway agreed to acquire all of the assets of the San Gabriel Company and to dissolve it. (R. 79.)

The contract further provided that in ascertaining net profits, which was to be done quarterly, "there shall be deducted from the gross receipts, in

addition to other deductions, a sum of money equal to six (6%) per cent per annum" figured on the net advances made by the Midway Company for the payment of the debts of the San Gabriel Company and for the development of its properties. (R. 79.)

In accordance with the contract, the Midway Company (name since changed to California Petroleum Corporation of California) acquired all of the assets of the San Gabriel Company and dissolved it, and developed and operated the oil properties thus acquired, and paid respondent one-third of the net profits to August 4, 1926. (R. 44–45.) (Subsequent payments were made to Mrs. O'Donnell (R. 46), which the court below held were taxable to her.)

The petition to the Board involved O'Donnell's right to deduct percentage depletion on the payments received by him under the above contract. (R. 22.) The Board allowed the claimed depletion. The Circuit Court of Appeals affirmed the Board.

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the taxpayer, under his contract with the Midway Company, acquired an economic interest in oil in place.

2. The Circuit Court of Appeals erred in holding that the taxpayer was entitled to a 27½% depletion allowance on the payments he received under his contract with the Midway Company.

REASONS FOR GRANTING THE WRIT

1. In holding that the respondent acquired an economic interest in oil in place, the Circuit Court of Appeals improperly extended and misapplied the decision of this Court in *Palmer* v. *Bender,* 287 U. S. 551. In the *Palmer* case this Court held that one who had retained the right to share in the *oil* produced from an oil well had an economic interest in the oil in place, subject to depletion.

Prior to the transfer of his stock, the taxpayer had no economic interest in the oil in place, but only a right to receive dividends from the profits derived by the corporation from the leases. The instant case is, therefore, unlike *Palmer* v. *Bender, supra,* and *Thomas* v. *Perkins,* decided June 1, 1937, No. 824, October Term, 1936, where the assignors had previously been lessees and transferred their rights to others, retaining an interest in the production.

The taxpayer did not acquire an economic interest in the oil in place by the transfer of his stock, but only the right to share in the *net profits* from the operation of the properties.[1] He acquired neither the right to share in kind in the oil produced and saved, as in *Palmer* v. *Bender, supra,* nor a right to receive the value in cash of a speci-

[1] The Circuit Court of Appeals said: "The only right or interest respondent ever had in or under the contract was the right to receive one-third of the net profits from the development and operation of the oil properties * * *."

fied proportion of the oil, as in *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 321, nor a right to receive a specified amount out of the gross proceeds of the oil, as in *Thomas* v. *Perkins, supra.* His only interest was a right under the contract to receive a specified proportion of Midway's net profits, if any, from operation of the oil leases, to be determined by deducting from gross receipts not only operating expenses but the stipulated interest payments as well. Such an interest cannot be said to constitute that *ownership* either of the oil produced or of the gross proceeds of the oil which under the statute is essential.

In *Thomas* v. *Perkins, supra,* this Court in discussing the *Palmer* case said:

> Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save to them an economic interest in the *oil* sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.* [Italics supplied.]

The Court pointed out that there is no difference, so far as ownership is concerned, between percentage and cost depletion.

The depletion allowance is a percentage of "gross income." "Gross income" from the property means gross receipts from the oil extracted.

Helvering v. *Twin Bell Syndicate, supra.* Ownership of the oil is essential to determine whose is the gross income, since the ownership of gross income determines the right to the depletion allowance. In the instant case Midway owned the oil produced. To it belonged the gross proceeds from the sale of the oil. These proceeds O'Donnell cannot in any sense be said to have owned. The amounts payable to him were part of Midway's net income.

2. The question is of considerable importance. Many cases are now pending involving this or similar questions. Continued misapplication of the *Palmer* decision endangers the revenues in large sums, for depletion erroneously allowed to one may rightfully be claimed by another.

Petition for certiorari has heretofore been filed in *Helvering* v. *Bankline Oil Co.*, No. 387, October Term, 1937, involving a closely related question.

CONCLUSION

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted.

STANLEY REED,
Solicitor General.

SEPTEMBER 1937.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 916, 26:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made

under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

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